Document of
The World Bank

Report No: 18314-KO

PROJECT APPRAISAL DOCUMENT

ON A

PROPOSED LOAN

IN THE AMOUNT OF US$48 MILLION

TO THE

REPUBLIC OF KOREA

FOR A

FINANCIAL AND CORPORATE RESTRUCTURING ASSISTANCE PROJECT

AUGUST 6, 1998

Private Sector Development Unit
East Asia and Pacific Regional Office

CURRENCY EQUIVALENTS

(Exchange Rate Effective July 1, 1998)
Currency Unit = Won (W)
W 1.00 = US$0.000725
US$1.00 = W1,380

FISCAL YEAR

January 1 - December 31

ABBREVIATIONS AND ACRONYMS

ADB	-	Asian Development Bank
BIS	-	Bank for International Settlements
BOK	-	Bank of Korea
CAS	-	Country Assistance Strategy
Chaebol	-	Business Group
FSB	-	Financial Supervisory Board
FSC	-	Financial Supervisory Commission
GDP	-	Gross Domestic Product
GOK	-	Government of Korea
IFC	-	International Finance Corporation
IMF	-	International Monetary Fund
KAMC	-	Korea Asset Management Corporation
KDI	-	Korea Development Institute
KDIC	-	Korea Deposit Insurance Corporation
KFTC	-	Korea Fair Trade Commission
KICPA	-	Korean Institute of Certified Public Accountants
KIET	-	Korea Institute of Economy and Trade
KLTCB	-	Korea Long-Term Credit Bank
KSDA	-	Korea Securities Dealers Association
KSE	-	Korea Stock Exchange
KSRI	-	Korea Securities Research Institute
M&A	-	Mergers and Acquisitions
MOFE	-	Ministry of Finance and Economy
MOJ	-	Ministry of Justice
NBFI	-	Non-Bank Financial Institution
NLS	-	Non-Lending Service
OECD	-	Organizations for Economic Cooperation and Development
PIU	-	Project Implementation Unit
SAL	-	Structural Adjustment Loan
SFOU	-	Special Financial Operations Unit
SME	-	Small and Medium-sized Enterprise
SSB	-	Securities Supervisory Board
SRO	-	Self Regulatory Organization
TA	-	Technical Assistance
TOR	-	Terms of Reference

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Korea
Financial and Corporate Restructuring Assistance Project

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Korea
Financial and Corporate Restructuring Assistance Project

Project Appraisal Document

East Asia and Pacific Regional Office
Korea Country Management Unit

Date: August 6, 1998	Task Team Leader: Klaus Lorch
Country Director: M. G. Sri-Ram Aiyer	Sector Manager: Hoon Mok Chung
Project ID: KR-PE-56796 Sector: Finance, PSD	Program Objective Category: PV, EA
Lending Instrument: TA Loan	Program of Targeted Intervention: [ ] Yes [x] No

Project Financing Data [x] **Loan** [] **Credit** [] **Guarantee** [] **Other [Specify]**

For Loans/Credits/Others:

Amount: US$48.0M
Proposed terms: [] Multicurrency [x] Single currency, U.S. dollars
Grace period (years): 5 [] Standard Variable [] Fixed [x] LIBOR-based
Years to maturity: 15
Commitment fee: Standard
Service charge: Not applicable

Financing plan (US$ M):

Source	Local	Foreign	Total
Government	3.8	2.7	6.5
Cofinanciers	-	-	-
IBRD	0.9	47.1	48.0
IDA	-	-	-
Other	-	-	-
Total	**4.7**	**49.8**	**54.5**

Borrower: The Republic of Korea
Guarantor: -
Responsible agencies: Ministry of Finance and Economy (MOFE), Financial Supervisory Commission (FSC), Ministry of Justice (MOJ), and Korean Fair Trade Commission (KFTC).

Estimated disbursements (Bank FY/US$ M):	1999	2000	2001	2002
Annual	23.0	19.0	5.0	1.0
Cumulative	23.0	42.0	47.0	48.0

Project implementation period: September 1, 1998 to December 31, 2001
Expected effectiveness date: September 1, 1998 Expected closing date: June 30, 2002

A: Project Development Objectives

1. Project development objective and key performance indicators (see Annex 1):

This project aims to provide technical assistance to support reforms in the areas central to the efforts of the Korean Government for effective management of the problems in the financial and corporate sectors and for sustained strong and stable growth in today's more integrated and competitive global economy: financial sector restructuring and development, including capital market development; and corporate sector reform, including corporate restructuring and reform of corporate governance and competition policies. The project supports measures to:

(i) reduce the likelihood of systemic failure in the banking and corporate sectors through strengthening the capacity for monitoring and managing financial crisis in these sectors, and deepening the structural reforms; and reduce economic risks through improved debt management;

(ii) improve the financial soundness of banks and corporations, particularly their financial leverage, through strategy formulation, improvement of the financial sector regulatory framework, strengthening of securities markets, work-out of corporations driven by their lead banks with the help of an arbitration committee, and the deepening of capacity for restructuring banks and corporations; and

(iii) deepen a broad process of change in state institutions, banks and corporations towards less government involvement in business, better enterprise transparency and governance, stronger focus on financial results, and more openness to global competition and investment through the catalytic role of advisors with international experience, institutional development in newly structured entities like FSC, and the strengthening of self-regulatory institutions.

This project would be part of a broader effort supporting Korea's stabilization and structural adjustment program to restore sustainable high rates of economic growth. It would complement the three-year stand-by facility provided by the IMF and the emergency financing package from bilateral and multilateral sources. The project is the first large-scale technical assistance loan to buttress this assistance. An Economic Reconstruction Loan was approved by the Board on December 23, 1997 in support of the Republic of Korea's rapid initiation of a program of actions, objectives and policies designed to achieve economic reconstruction through long-term stabilization of the Korean economy. A Structural Adjustment Loan was approved by the Board on March 26, 1998 to support a program of wide-ranging and deep reforms aimed at bringing about a major restructuring of incentives and institutional framework to underpin financial stability, improve efficiency and competitiveness, and enable Korea to return to a path of robust and sustained growth.

B: Strategic Context

1. Sector-related Country Assistance Strategy (CAS) goals supported by the project (see Annex 1):

CAS document number: N/A Date of latest CAS discussion: Country Strategy Note dated 6/24/93

There is no recent CAS, but a CAS is being initiated at present. The Bank assistance strategy as outlined in the SAL President's Report dated March 5, 1998, and discussed by the Board of Executive Directors, identified two main objectives: Restoration of financial stability and resumption of financially sustainable growth. The Bank would support these objectives by helping define and implement a structural reform program, through adjustment lending and technical assistance activities. The proposed Financial and Corporate Restructuring Assistance Loan would support key elements of the structural reform program, thus helping the implementation of the above SAL as well as the on-going preparation and future implementation of a SAL II.

The proposed Loan would help:

(i) avoid major financial instability, mainly through enhanced crisis management capability for the banking and corporate sectors;

(ii) underpin it by supporting the rehabilitation and recapitalization of banks, as well as the restructuring and leverage-reduction of corporations; and

(iii) reform incentives and the institutional framework to facilitate financially sustainable growth in the context of today's integrated and competitive global economy.

2. Main sector issues and Government strategy:

The performance of the Korean economy has been remarkable for the past three decades. The broadly favorable performance, however, masked weaknesses that contributed to the current crisis. Although government intervention enabled the economy to grow rapidly over the last decades, it preserved a protected and inefficient financial sector as well as a highly leveraged and concentrated corporate sector. Weak corporate governance and moral hazard problems have resulted in financial institutions' portfolio problems as well as funding mismatch and foreign exchange risks.

In the face of mounting financial difficulties in the corporate and financial sectors, the Government committed itself to wide-ranging structural reforms. The starting point was restructuring and reform of the financial sector, but the focus was soon expanded to include the corporate sector as well. Restructuring of these sectors has been complemented with reforms in their framework, such as corporate governance and structure; enhanced competition policies; strengthening of the insolvency process; trade and capital account liberalization; and macroeconomic policies to continue adjusting the current accounts, building up foreign exchange reserves, containing inflationary pressure through tighter monetary policy and significant fiscal adjustment. At the same time, the country's new administration is attempting to change widespread patterns of behavior and orientation that have underpinned the inefficient investment and excessive leveraging of the past.

In sum, the authorities face a challenge of daunting magnitude and complexity: (i) managing a financial crisis that carries risk of systemic failure not only in the banking but also in the real sector, and that already entails the economic loss and social consequences of a high number of small and medium enterprise (SME) bankruptcies; (ii) ensuring the re-capitalization of viable banks and viable large-scale enterprises which are uniquely over-leveraged; and (iii) addressing underlying paradigms, behaviors, incentives, etc. that have led to the excessive and inefficiently used debt funding.

The sheer magnitude of the problem creates various difficulties. Leverage-reducing measures such as tapping the local stock market, attracting foreign strategic investors, or selling domestic assets face absolute limits in this aggregation. Skills in bank and corporate restructuring are scarce domestically since the phenomenon had been rare, and international experts in these areas generally lack first-hand experience in Korea. Banks need to engage in the drastic restructuring of many large debtors while undergoing drastic restructuring themselves. Small and medium enterprises are faltering in masses due to lack of on-going funding facilities irrespective of their viability, yet the capacity is lacking in the short term to triage and work-out hundreds of thousands of such firms with any degree of responsible diligence. Financing of state measures through bonds or privatization proceeds, unless carefully structured and timed, threatens to compete with corporations' recapitalization efforts in the securities market.

The key elements of Government strategy for a comprehensive restructuring and strengthening of the financial sector, which remains a centerpiece of the overall reform program, are:

- bank diagnostic studies including review of loan portfolio, trust accounts, and guarantees.

- bank efforts at loan collection/foreclosure and bank-led loan renegotiation, debt-equity swaps, and other work-out measures.
- bank recapitalization mainly through asset purchases by the Korea Asset Management Corporation (KAMC), GOK injection of bonds into banks, and fresh equity from existing and new shareholders.
- many owners/managers forced out of controlling positions; some banks to be closed, or under de facto conservatorship and offered for sale to new owners; implementation of bank restructuring plans agreed with and monitored by FSC; and
- improved transparency through better accounting, reporting, minority shareholder rights, etc.; strengthened prudential regulations and enforcement powers; supervisory authority unified for the entire financial sector.

Addressing vulnerabilities and rising to the new challenges call for a radical restructuring of the incentives and institutional framework in the Korean economy. The Government recognizes that the strategy in the corporate sector requires:

- monitoring of corporate financial crisis in a "war room" mode; managed shift away from "cooperative" anti-bankruptcy financing; ban on cross-guarantees; initial rough triage; debt so far rolled over for SMEs, except those identified as non-viable; expansion of credit guarantees for viable SMEs that are cut off from prior funding sources;
- widespread financial work-outs assisted by financial advisory consortia; for the 5 largest *chaebols* and for other *chaebol* companies by lead banks, especially eight to nine of the largest banks; involves debt and guarantee restructuring, debt-equity swaps, asset sales, new equity, investment deferral to use the depreciation shelter, etc.; arbitration committee to get active where creditors fail to agree among themselves within a short time; backed up by improvements in the framework for bankruptcies and court administration/mediation;
- unprecedented extent of re-capitalization of corporations through asset sale, new strategic investors, debt-equity swaps, 'haircuts' of creditors, employee shares, mutual funds, etc.; facilitated by higher transparency, improved framework for governance, and strengthened securities markets;
- continued business restructuring to focus on core competencies, reduction of excess labor, reconfiguration of group structures, and efficiency enhancements to compete in an opening economy; and generally a 'cultural change' towards financial results, risk management, transparency, minority shareholders' interests, and arms' length relationship with government; and
- privatization of state enterprise shares and private participation in new infrastructure projects, with the short-term objective of raising/saving state funds for bank recapitalization and social protection, and the longer term objective of removing Government from business.

3. Sector issues to be addressed by the project and strategic choices:

The project would help to address many of the above issues, as described in section C below, through the provision of technical assistance. It would help to:

- further develop and flexibly adjust the reform strategy in the two sectors;
- build the institutional capacity to implement the program; and
- directly support the implementation of key program elements.

C: Project Description Summary

1. Project components (see Annex 2 for a detailed description and Annex 3 for a detailed cost breakdown):

Component	Category	Cost Incl. Contingency (US$M)	% of Total	Bank-financing (US$M)	% of Bank-financing
1. Fin. Sector Supervision and Crisis Management	Inst. Building	9.60	17.6%	7.30	76.0%
1.1 FSC Institutional Development					
1.2 Fin. Sector Crisis Management Capability					
2. Securities Markets Development	Ditto	1.95	3.6%	1.44	73.8%
2.1 Market Regulat., Infrastructure, Industry					
2.2 Government Bond Markets					
2.3 Accounting and Audit Reform					
3. Debt Management Improvement	Ditto	2.50	4.6%	2.00	80.0%
4. Corporate Restructuring	Ditto	32.70	60.0%	30.50	93.3%
5. Corporate Legal/Regulatory Reform	Ditto	1.70	3.1%	1.50	88.2%
5.1 Insolvency System					
5.2 Governance Framework					
6. Competition Policy	Ditto	0.61	1.1%	0.42	68.9%
7. Project Implementation Support	Ditto	0.22	0.4%	0.20	90.9%
Contingency	Ditto	5.22	9.6%	4.64	88.9%
	Total	54.50	100.0%	48.00	88.1%

2. Key policy and institutional reforms supported by the project:

The proposed project would support the following key reforms in financial sector:

- institutional strengthening of financial sector supervision for the longer run, including: (i) improvement of strategies, policies, procedures, and capabilities to adopt and enforce prudential regulations and implement supervisory practices in line with accepted international practices, and aimed at enhanced coordination of supervision across the financial sector in a unified institutional setting; and (ii) the implementation of a new organizational structure of the Financial Supervisory Commission (FSC), including new operational policies and human resource development programs;
- strengthening of FSC's capability to manage financial crisis in terms of policies, procedures and implementation capacity, particularly through (i) development of bank evaluation, restructuring and recapitalization processes; and (ii) implementation mechanisms for the above;
- enhancing the development of securities markets, through (i) reform of the regulatory framework towards stronger self-regulation, rationalization of the market architecture, and redefining the securities industry aimed at higher levels of innovation and competitiveness; (ii) strengthening of Government bond markets, particularly primary and secondary markets; and (iii) reform in the areas of accounting and audit; and
- improving the soundness of Government debt management, through strengthened professional capability, information systems, and organizational arrangements.

Timely and adequate restructuring of financially distressed/insolvent corporations is promoted concerning corporate restructuring, in particular towards lower debt-equity ratios and higher interest coverage, in ways that would minimize strains on the court system and generate rapid trickle-down benefits for SMEs. This would be addressed by:

- vastly enhancing the capacity of the main commercial banks to work out large corporate borrowers; and
- in the process, building sustained institutional capacity for corporate restructuring in these banks, their inter-creditor arbitration committee, and a number of enterprises subject to restructuring.

The strengthening of corporate governance is critical for sustaining the results of financial and corporate sector restructuring. Corporate governance would be enhanced specifically through:

- establishment of a more reliable corporate insolvency system that ensures a balance of stakeholder interests;
- development of credible mechanisms to encourage the monitoring of corporate performance by various stakeholders (directors, shareholders, creditors, regulators, media); and
- increased effectiveness of competition policy, in particular the application of the Fair Trade Act.

3. Benefits and target population:

The project is a strategic follow-up to Bank assistance to the Government following the recent financial and foreign exchange crisis. This project will: (i) reduce the likelihood of systemic failure in the financial as well as corporate sectors; (ii) make the recapitalization of the banking system as well as the corporate sector more rapid, effective, and economically efficient than it would be without the assistance program; and (iii) deepen a process of change towards, *inter alia*, better enterprise transparency and governance, a focus on financial results rather than operational size, and less Government involvement in business.

The target beneficiaries in a wide sense would be investors, employees, and consumers of Korean corporations and banks. Direct beneficiaries will include implementing institutions that would be strengthened institutionally (such as FSC and KFTC), as well as several commercial entities (eight main commercial banks, and some 6-12 very large corporations undergoing particularly in-depth restructuring by these lead banks).

4. Institutional and implementation arrangements:

The implementation period of the Loan would cover a period of about three years, and complement the adjustment lending provided by the Bank and help generate sustained institutional change.

The executing agencies under the project would be the Ministry of Finance and Economy (MOFE) and Financial Supervisory Commission (FSC). A ***Project Implementation Unit*** (PIU) will be established at MOFE to help manage components 2, 3, 5 and 6 of the project and ensure coordination of the different project components. This PIU will be formed within the Treasury Division of MOFE. It will be directed by the Director of the Treasury Division. A senior staff from the Treasury Division would act on a part-time basis as Deputy Director with powers to hire and request disbursements from the Bank. This PIU would, *inter alia*, manage a special account, carry out accounting, engage independent auditors, prepare and send disbursement requests to the Bank, advise the various technical implementing agencies in procurement matters consistent with Bank guidelines, and compile quarterly and mid-term project progress reports.

A second PIU has been established at FSC to help manage components 1 and 4 of the project. This PIU has been formed within the Planning and Administration Department of FSC. It is directed by the

Director General of this Department. A senior staff from the Department will act on a part-time basis as Deputy Director with powers to hire and request disbursements from the Bank. The functions of this PIU will be the same as those described above for the PIU at MOFE, including the management of a second special account.

Under the overall coordination of MOFE, several implementation agencies would be the focus of the project activities, including the Financial Supervisory Commission (FSC), Ministry of Justice (MOJ), Korean Fair Trade Commission (KFTC), and MOFE itself. These agencies would be responsible for carrying out their respective project components. These agencies would carry out procurement, contract the consultants, and manage them. They would also carry out the few, minor cases of procurement of goods.

A *Project Steering Committee* comprising representatives of these agency representatives would convene regularly under the chairmanship of the Director of MOFE's Treasury Division to coordinate Project implementation activities and monitor progress. On the Bank's side, supervision would be carried out by the East Asia & Pacific Region's Private Sector Development Unit in coordination with the Country Management Unit based in Seoul and more specialized staff in units at headquarters.

The various components of the proposed project must be carried out according to *terms of reference* acceptable to the Bank. Any training, study tours and workshops under this project would be carried out according to programs and timetables acceptable to the Bank. Terms of reference for the key project phases were agreed upon during negotiations. Detailed implementation plans for each component would be regularly updated and submitted to the Bank for approval during project implementation.

Accounting, Reporting, and Auditing. The project accounts and financial reporting would be done in accordance with standards acceptable to the Bank. The two PIUs would be responsible for keeping financial records and expenditures incurred for different components of the Project, as well as monthly financial management reports. The two PIUs would also prepare quarterly project progress reports, and each implementing agency would be responsible for preparing inputs to these reports. Project management teams in MOFE and FSC including a qualified accountant based in MOFE and another in FSC, would keep track of all financial transactions and be responsible for producing project accounts. Project accounts including Statements of Expenditures and Special Accounts would be audited annually by the independent auditors acceptable to the Bank. Copies of annual financial statements, audited reports (including Special Accounts and Statements of Expenditures audit opinions) would be submitted to the Bank within six months of the end of the fiscal year. Based on the Guide for Review and Design of Accounting and Reporting Systems prepared by the Bank's East Asia and Pacific Region, the control environment of implementing agencies is being assessed, and an appropriate accounting and reporting system developed according to the requirements of OP/BP 10.02. The system, including progress and financial reporting, will be prepared and is expected to be ready for implementation by the time of project effectiveness. Qualified accountants will be designated or recruited to prepare and manage the financial management aspects of the Project.

Monitoring of project execution will be undertaken by the PIUs which will submit to the Bank for its approval initially quarterly project progress reports within one month after the end of each quarter year, starting with a first report by 10/1999. After the first year of the Project, semi-annual project progress reports will be submitted within one month after the end of each half year. The quarterly and semi-annual reports would include (a) a retrospective assessment in meeting agreed outputs, and (b) working plans for the following six months. A mid-term review of the project will be submitted by the PIUs to the Bank by November 30, 1999 to assess progress in project implementation and to set out measures recommended to ensure the efficient carrying out of the project and achieving the project objectives.

D: Project Rationale

1. Project alternatives considered and reasons for rejection:

The Government has demonstrated its commitment to taking the measures needed to stabilize the economy and the financial sector. At the same time, the Government recognizes that major institutional and structural weaknesses need to be remedied to sustain that stability. The proposed project aims to assist the Government in these endeavors in specific areas as requested by the Government. An important principle in developing the Project was to respond quickly and constructively to a set of priority needs. The proposed assistance would enhance the technical capability of the Government for effective management of the problems in the financial and corporate sectors, and for sustained and stable growth in the increasingly integrated and competitive global economy.

The first alternative considered was non-lending service, with reimbursement by the Government, to help prepare and supervise various consultants engagements which would be funded by the Government without a Bank Loan. It has been rejected, however, taking into consideration that the client's leadership seeks a more direct, visible role of the Bank in the provision of consultancy so as to convince lower levels of bureaucracy of the benefits of consultant services, and to ensure proper incentives for the Bank to consistently ensure their effective use. Moreover, the Government finds the Bank's Loan terms advantageous compared to alternative sources at this point in time.

Several smaller TA loans were also considered, with a view to facilitating their management. This alternative was rejected for several reasons: Parliamentary approval for several operations would be more difficult than for one; the main components of the proposed loan are closely linked; all main components are needed urgently at the same time; and total costs for the Bank would be higher. Social security reform, however, would be addressed under the ASEM grant and potentially other grants, because its inclusion would make the proposed Loan excessively complex in scope, counterparts and expertise.

2. Major related projects financed by the Bank and/or other development agencies (completed, ongoing and planned):

Sector Issue	Project	Latest Supervision (Form 590) Ratings (Bank-financed projects only)	
		Implementation Progress (IP)	Development Objective (DO)
Bank-Financed			
Structural Reform in Fin. and Corp. Sectors	SAL I (3/98)	-	-
Deepening of Structural Reforms	SAL II (planned)	-	-
Banking Sector Reform Strategy	Advice by SFOU (NLS)	-	-
Credit Line for Real Sectors	Financial Intermediation Project (ongoing since 1994)	S	S
Other Development Agencies			
Stabilization and Structural Reform	IMF Standby	-	-
Asset Resolution (KAMC), Asset Securitization, Banking Supervision	ADB: Financial Sector Restructuring and Development Assistance Project	-	-
Bank Strengthening (Korea Long-Term Credit Bank; Hana Bank) and Provision of Working Capital	IFC (since 1968/71); 6/98 approval of equity, convertible bonds and credit for Hana Bank, and convertible bonds for KLTCB	-	-
Potentially: Establishment of Private Equity Fund(s)	IFC (identification)	-	-

IP/DO Ratings: HS (Highly Satisfactory), S (Satisfactory), U (Unsatisfactory), HU (Highly Unsatisfactory)

The Project would be complemented by several Bank-administered grants:

(i) A Special PHRD grant of US$1.45 million is supporting some urgent actions of financial sector reform including, *inter alia*, legal counsel required in the course of bank diagnostic studies.

(ii) A second Special PHRD grant of about US$1.35 million is expected to aim at corporate restructuring. It would finance some corollary activities to the Project's corporate restructuring component such as the development of strategies and programs for SME restructuring, special studies on longer-term strategies to improve the capitalization of large enterprises; and the design and start-up of a monitoring and analysis system for the reform of administrative regulations affecting business.

(iii) ASEM grant funding is expected to help strengthen the capacity of the social protection system and labor market institutions to respond to rapidly rising unemployment.

The Korea Asset Management Corporation, which is playing an important role in carving out and disposing of bank assets, is being supported by the Asian Development Bank. The Asian Development Bank has notionally allocated a third of its US$15 million Technical Assistance program to this support, but is prepared to raise this share if and when the need arises.

3. Lessons learned and reflected in the project design:

Situations of economic stress call for assistance to be timely and flexible. Complex technical assistance loans, however, are hard to implement in a rapid manner. Project design has sought to address these lessons by limiting the number of direct clients to four; electing one central implementation unit to assist procurement and handle disbursement; focusing on few large components with large-size contracts; referring to grant funding some small components that had been proposed for the Project; delegating responsibility for supervision of major components to SFOU and PSD; and ensuring sufficient supervision budget.

The restructuring of the banking sector and corporate sector must be closely coordinated if problems are widespread in both. Creditors to be sound need sound borrowers, and borrowers to become sound need the pressure and cooperation of strong creditors.

Poor governance in banks and corporations contributed critically to the economic crisis. The proposed project would address governance through components for accounting, bankruptcy system, legal framework for governance, competition policy and securities markets, and by encouraging profound restructuring that involves changes in ownership, management, etc.

4. Indications of borrower commitment and ownership:

The Government has urged the Bank to prepare the proposed Project within a very short time frame. The Government is convinced that prompt action towards fundamental structural adjustment is required to rebuild investor confidence, limit wider adverse repercussions of the financial crisis, and return the economy to sustained strong and stable growth. Strong commitment to the Project has been expressed particularly by high-level officials in the key client agencies, including the President's Office and FSC; the latter would receive the largest part of the Loan proceeds.

5. Value added of Bank support in this project:

The extensive use of advisory teams with international experience is practically indispensable, in Korea as elsewhere, in areas such as the diagnostic or restructuring of large corporates and banks. Furthermore, the magnitude of the restructuring task in the banking and corporate sectors is extraordinary, and local experience in these areas has developed only to limited extent in the formerly fast-growing economy. As a result, the local capacity to handle the challenge is insufficient unless supplemented by large amounts of external advisory services. Moreover, the consultants would be catalysts for fundamental change in the objectives/mission, orientation, policies, practices, skills mix, etc. of the recipient institutions. Bank involvement in preparation and supervision would help ensure the effective and efficient use of such advisory teams. The Project would also enhance the opportunities for the Bank to bring its best practice expertise to bear in discussions on Korea's crisis resolution and structural reform policy. Moreover, the Bank's involvement would help send a confidence-building signal to markets/investors. Finally, the Loan would help relieve the stress that bank recapitalization, social protection, and other crisis-related measures will put on Government finances.

E: Summary Project Analysis

1. Economic:

Not applicable.

2. *Financial:*

The project is expected to yield significant returns by augmenting the Korean Government's efforts to (i) achieve macro economic stabilization of the economy; (ii) comprehensively strengthen the financial sector, as well as its prudential regulations and their enforcement; (iii) improve corporate governance and financial transparency; and (iv) enhance the resiliency and international competitiveness of Korea's industrial sector.

Fiscal impact:

The Project is expected to assist in minimizing the fiscal impact and increasing the fiscal revenue base by (i) reducing the risk of wide uncontrolled failure in the banking sector; (ii) strengthening the Government's ability to anticipate corporate defaults and to facilitate timely, market-based responses by financial institutions, and developing procedures and institutions to support timely conclusion of complex voluntary workouts; (iii) limiting state funds required for bank recapitalization; and (iv) accelerating the withdrawal of Government from business.

3. Technical:

The Project will ensure that the Korean Government obtains access to high quality expertise and international best practice available from international consultants and training opportunities.

4. Institutional:

a. Executing agencies:

The Project aims to improve the capability of key economic agencies (Ministry of Finance and Economy, Financial Supervisory Commission, Korean Fair Trade Commission) and other related implementation agencies, particularly the Ministry of Justice (MOJ), to formulate and implement polices to deal with economic crisis and strengthen the regulatory environment for sustained and stable growth.

b. Project management:

The Project will be coordinated by forming an inter-agency Project Steering Committee. Project implementation capacity will be deepened particularly at MOFE and FSC.

5. Social:

Not applicable

6. Environmental assessment: Environmental Category [ ] A [ ] B [x] C

No major environmental issues are expected to accrue from implementing the Project. Loan funds would not be available to real-sector enterprises. The corporate restructuring, for which the Project would fund financial advisory teams, may occasionally have an influence on environmental issues, mainly where restructuring involves closure of facilities, bankruptcy of their operators, or enterprise sale. Accordingly, terms of reference of financial advisory consortia would require that potentially substantial environmental liabilities be taken into account in cases of enterprise closures, bankruptcies and sale in the light of an early review of the relevant legal and regulatory framework.

7. Participatory approach:

a. Primary beneficiaries and other affected groups:

Consultations were held with a wide range of stakeholders, including representatives from relevant government agencies including MOFE, FSC, MOJ, and KFTC, financial institutions, corporations and non-government organizations, e.g., KICPA and the Korean Securities Research Institute.

b. Other key stakeholders:

Discussions were held with the Federation of Korean Industries, the Bankers Association, and various research institutions. The interlocutors gave their views and recommendations on restructuring needs in the financial and corporate sectors, constraints to such restructuring and actions to remove them, and the potential role of various parties in the process.

F: Sustainability and Risks

1. Sustainability:

Sustainability of project *outputs* would come from the learning experience under the project. This experience would help to expand and continue the initially Bank-funded restructuring actions to additional banks and corporations.

Sustainability of project *outcomes* would depend largely on the nature and scope of the crisis resolution measures. A future repeat of bank recapitalization should be avoided by assessing banks' financial condition realistically, limiting moral hazard through burden-sharing with bank owners, managers and creditors, and changing the culture of lending and risk-taking. A future repeat of sweeping corporate restructuring should be avoided by making the present restructuring sufficiently deep (beyond mere financial rearrangements), paradigm-changing for the stakeholders, and confidence-inspiring for new investors.

Sustainability of project *impact* is enhanced by addressing long-term strategic and institutional issues in addition to shorter term crisis resolution: capacity building for bank supervision in addition to banking crisis management; improvements in the governance framework in addition to corporate restructuring; and strengthening of securities markets.

2. Critical Risks (reflecting assumptions in the fourth column of Annex 1):

Risk	Risk Rating	Risk Minimization Measure
Annex 1, cell "from Outputs to Objective"		
External events may drastically affect Korea's prospects for crisis prevention/resolution and financial recovery.	S	Crisis management assistance under the Project, as well as intensive Project supervision and related NLS, to help early identification and rapid response to external shocks.
Government, formed by a coalition without parliamentary majority, may face difficulties implementing reforms with appropriate consistency and resolve.	H	Assurances of leadership's commitment to profound reform, especially in context of SAL I and to be sought under SAL II.
Organized labor may hinder real sector restructuring in the depth and time-frame required and, in the process, weaken the recovery of investor confidence.	H	Restructuring to involve visible burden-sharing of owners and managers, as per tripartite agreement in early 1998; Bank assistance and its outcomes to inspire investor confidence.
The banks who are to lead corp. restructuring will themselves at the same time be subject to drastic restructuring, including merger with, or assumption by, other banks. This may affect their incentives, focus, and implementation capacity in corporate restructuring.	S	Consultant teams for lead banks contracted by FSC.
Changes of institutional culture in Government and business towards more transparency and less Government intervention may face resistance, and may affect the timely and effective use of the advisory services.	S	The country's leadership unambiguously pursues these changes as a fundamental for sustained growth in today's global economy.
Annex 1, cell "from Components to Outputs"		
Parliamentary discussions or Governmental budget and administrative procedures may cause delay in effectiveness, and delay even of Project actions that would be eligible for retroactive financing.	S	Staff communication with representatives of relevant parliamentary commission(s), and recent assertion of high-level authorities' commitment to accelerated processing.
Clients' implementation capacity is constrained by crisis management workload, repeated restructuring and multiplicity of institutions, and shortage of prior experience in key areas like financial restructuring.	S	Main project components to strengthen the core of the Government's crisis resolution and restructuring capacity.
Consultant procurement procedures may cause critical delays in start-up of crisis-resolution activities.	S	Possibility of sole-sourcing and shortened bidding periods of selected contracts, on an exceptional basis.
Project supervision budget of IBRD may not be sustained in adequate volume through peak implementation period.	M	FY99 supervision budget about $350,000, mostly from the Special Financial Operation's budget.
Overall Risk Rating	H	

Risk Rating - H (High Risk), S (Substantial Risk), M (Modest Risk), N (Negligible or Low Risk)

3. Possible Controversial Aspects:

None.

G: Main Loan Conditions

1. Effectiveness Conditions:

Effectiveness Conditions of the Loan are: (i) to establish, and assign adequate numbers of staff to, the Project Implementation Units (PIUs) (see C.4); and (ii) to establish and appoint members of a Project Steering Committee (see C.4).

2. Other:

Key Covenants of the Loan are: (i) open and maintain two Special Accounts in US dollars at commercial banks acceptable to the Bank on terms and conditions satisfactory to the Bank; (ii) carry out annual audits of the consolidated project accounts, Special Account, and statements of expenditures and submit audit reports to the Bank not later than four months after the end of each fiscal year; (iii) submit quarterly project reports and draft work plans, starting end-September 1998 for one year, and semi-annual project reports and work plans thereafter; (iv) assess progress in project implementation pursuant to agreed Performance Indicators; (v) carry out a mid-term project implementation review by September 30, 1999 and a Project implementation completion review within six months after Project completion (see C.4); (vi) undertake project activities in accordance with terms of reference and implementation timetables agreed with the Bank; (vii) carry out training activities in accordance with programs and timetables acceptable to the Bank; (viii) carry out studies in accordance with terms of reference and a schedule satisfactory to the Bank; (ix) procure equipment in conformity with applicable Bank guidelines; (x) maintain the PIUs and Steering Committee until Project completion; (xi) ensure the conduct of a review of the regulatory framework with respect to environmental impact, including potential environmental liabilities, associated with enterprise closure, bankruptcy, or sale, and ensure that advisors on corporate restructuring take into account such impact and potential liabilities in the light of this framework; (xii) establish appropriate steering committees for the coordination of the Project sub-components regarding insolvency and corporate governance; (xiii) enter into a collaboration arrangement with KICPA regarding the Project sub-components on accounting/audit reform.

H. Readiness for Implementation

[ ] The engineering design documents for the first year's activities are complete and ready for the start of project implementation. [x] Not applicable.

[x] The procurement documents for the first year's activities are substantially complete and ready for the start of project implementation.

[x] The Project Implementation Plan has been appraised and found to be realistic and of satisfactory quality.

[ ] The following items are lacking and are discussed under loan conditions (Section G):

I. Compliance with Bank Policies

[x] This project complies with all applicable Bank policies.

Task Team Leader: Klaus Lorch

Sector Manager: Hoon Mok Chung

Country Director: M.G. Sri-Ram Aiyer

ANNEX 1: PROJECT DESIGN SUMMARY

Narrative Summary	Key Performance Indicators	Monitoring and Evaluation	Critical Assumptions
Sector-related Strategy Goal:			(Goal to Bank Mission)
• Short-term: Reduced likelihood of systemic failure in the banking and corporate sectors	• No generalized collapse of banking and large-scale enterprise sectors	• Judgment by Steering Committee and Bank regional management	• No major external shocks
• Medium-term: Improved capitalization and structure in financial and corporate sectors	• Debt-equity ratio of banks and chaebols substantially improved	• Data compiled from GOK and research institutions	• Macroeconomic policies conducive to strengthening the fin. structure of banks and firms
• Long-term: Widespread change in corporate governance and transparency, corporate mission, and government-business relations	• Improved transparency, enhanced focus on financial results, and reduced Government role in business reported by market participants	• Dialogue with various stakeholders, including academics, local businessmen, foreign investors, etc.	• No broad withdrawal from change in reaction to social hardship and global market/investor influence
Project Development Objective:			(Objective to Goal)
• Short-term: Adequate action plans for financial and corporate sector adopted and implemented	• Adequate quality and timeliness of action plans, and largely consistent implementation	• Judgment by task team, confirmed by compliance with respective SAL conditions, and agreement on SAL II action program	• Governing coalition not paralyzed by internal dispute or by militant labor actions
• Medium-term: Debt-equity ratio of commercial banks and corporations substantially improved	• Commercial banks meeting BIS capital adequacy, or being under external supervision or closed; debt-equity ratio of large-scale, non-financial chaebol corporations substantially reduced	• Banks: financial statements confirmed by international standard audits. Corporates: GOK-compiled data on chaebol financial structure	• No major external shock and no severe internal labor strive
• Long-term: Significant changes in practices and orientation among agency and lead bank staff working directly with the advisory teams or participating in extended training	• Role of SROs (KICPA, securities markets) strengthened; FSC/lead banks actively seeking foreign capital in working out banks/debtors; expanded mandated disclosure to minority shareholders	• Review of policies, procedures, etc. emerging from and being applied under the Project	
Outputs:			(Outputs to Objective)
• Short-term: Strengthened action plans and implementation/monitoring capacity for banking sectors crisis management	• Revised, detailed action plans; monitoring systems established; advisors integrated into "war room" operational activities	• Project supervision in field; action plans submitted and reviewed	
• Medium-term: Viable commercial banks being restructured under FSC's purview; large chaebol corporations worked out by lead banks; non-viable banks/firms closed/liquidated or merged	• Banking: Large-scale commercial banking sector undergoing substantial restructuring. Corporate sector: At least 16 inter-linked business groups worked out with substantial assistance of project-funded advisors	• Regular project supervision	• Lead banks pursue work-out of major debtors with sufficient resolve and actively involve the advisors
• Long-term: Transmission of international best practice in policies, practices, institutional arrangements, etc.	• Consultancies utilized to the extent foreseen under the project and largely staffed with experts with extensive international experience	• Regular project supervision	• Counterpart staff remain open-minded to learning from international best practices
Project (Sub-)Components: (see Annex 2 for project description)	Inputs: (budget for each component)		(Components to Outputs)
• Short-term: (i) banking crisis management capacity	• Part of (i) $5.0 million	• Regular project supervision	• FSC engages external consultants of the nature, extent, and functions agreed
• Medium-term: (i) FSC institutional development (ii) Corporate restructuring (iii) corporate governance and securities markets	• Parts of: (i) $4.6 million (ii) $32.7 million (iii) $3.0 million	• Regular project supervision	
• Long-term: Generally all project components. Emphasis in: (i) corporate governance/insolvency (ii) competition policy	• In particular: (I) $1.7 million (ii) $0.6 million	• Regular project supervision	

ANNEX 2: PROJECT DESCRIPTION

Project Component 1: Financial Sector Supervision and Crisis Management - US$9.6 million
(of which Loan: US$7.3 million)

1.1 FSC Institutional Strengthening in Financial Sector Supervision (US$4.6 million)

Legislation passed on December 29, 1997 established the basis for a new financial supervisory system in Korea. A first step was the establishment of the Financial Supervisory Commission (FSC) on April 1, 1998, as an integrated financial supervision authority. Under the new system, all financial institutions (banking, securities, insurance and other non-bank institutions) are supervised by a single supervisory body, the FSC and its executive arm, the Financial Supervisory Board (FSB). The Chairman, Deputy Chairman and the Standing Commissioner are appointed by the Korean President. The reform calls for all four supervisory agencies (Banking Supervision Authority, Securities Supervision Board, Insurance Supervisory Board, and Non-Bank Financial Institution Supervisory Authority) to be fully integrated into the FSB by January 1, 1999.

It is expected that this integration of the supervisory function of all financial institutions will lead to harmonization and consistency in supervisory standards and practice and the regulatory framework, and lay the groundwork for enhanced competition among different types of financial service providers. Institutional strengthening of the supervisory function will improve government's official oversight of the financial system, enhancing systemic soundness. The proposed technical assistance will assist in achieving these objectives. (Considering the urgent need of the FSC to further develop and implement an overall strategy for financial crisis resolution, the proposed Project would through another sub-component also help strengthen FSC's crisis management capability.)

This institution-building would address:

(i) Development of FSC's strategies, policies, procedures and capabilities to adopt and enforce prudential regulations and implement supervisory practices in line with accepted international practices.

An analysis will be made of the differences between present Korean practices and international practices in prudential supervision. A strategy for prioritizing and implementing indicated improvements will follow from this evaluation. Assistance will focus on the following areas:

- *General On-site Supervision and Inspections Process.* FSC will recruit expertise to develop effective inspection policies and procedures, including consolidated supervision, in line with internationally acceptable norms. These policies and procedures will be institutionalized in a set of comprehensive inspection procedures manuals, and reinforced through on-the-job and classroom training programs.
- *Specialized Technical Expertise in On-Site Supervision and Inspection.* The Project would provide required expertise in new and complex fields such as derivatives, asset-backed securities, and investment banking. This would be achieved by the development and implementation of a permanent training program for staff including on-the-job training (with the assistance of seconded foreign experts) and training of supervisors abroad.
- *Financial Analysis Capability and Off-Site Supervision.* The Project would support improvements in technical analysis capabilities, the integration of financial analysis into the supervision process (on-site and off-site), and the development of indicators of financial group solvency and financial distress which would be reported to and monitored by FSC management.

- *Review of Regulatory Reports and Regulatory Accounting Principles.* The objective of this sub-component will be to upgrade the quality of data requested from individual financial institutions and groups. The current capacity of processing systems will be reviewed and upgraded so as to ensure integrity of data. The regulatory and output reports may also need to be redesigned so as to focus on the assessment of the financial risks undertaken by the financial institutions.

(ii) The implementation of FSC's new organizational structure, including the design and initial implementation of a human resource development program.

- *Implementation of FSC's new organizational structure.* Following the recommendations elaborated by an FSC Task force on Supervisory Organization Innovation with support by McKinsey consultants, the Project will assist in the implementation of the new FSC. This will include consultants to help develop FSC's internal information and communications systems, and to help formulate human resource policies and training programs to start up their operation.
- *Human Resource Development.* This component will introduce enhanced policies regarding human resource development at FSC. This will include the design and implementation of training programs to ensure adequate skills of supervisors, the development of mechanisms for ensuring the adequacy of FSC's staff skill mix and of standards for hiring new employees, the maintenance of adequate job descriptions, the definition of career development paths, and the elaboration of supporting compensation policies and systems. The implementation of training is expected to include the provision of a regular education program in bank supervision skills by a local training institution with help of trainers with broad international experience.

The core of the services and assistance would be provided by experts that have successfully participated in the financial crisis resolution of other countries and similar structural reforms in recent years. Some of the experts are expected to be seconded by foreign supervisory agencies.

Timing: 9/1998-12/2000 (28 months)

1.2 Financial Sector Crisis Management Capability (US$5.0 million)

While the newly established FSC builds its capacity for general financial supervision, it also needs to urgently strengthen its capability to respond to financial institution crisis. The FSC is charged with developing and implementing an overall strategy for financial crisis resolution. This is an immediately urgent task which is presently absorbing most of FSC's attention. To carry out this immediate task, a special unit (Structural Reform Planning Unit) has been established within FSC, reporting directly to the FSC Chairman and staffed in part with experts seconded by other agencies and Korean research institutions. The FSC will require substantial consultant support to operationalize strategies for the restructuring of banks and non-bank financial institutions.

The technical assistance would help develop strategies and processes, design an organizational structure, and introduce staff capabilities to effectively manage crisis among financial institutions. There would be two elements:

- *Support to the Strengthening of the Financial Institutions Crisis Resolution Strategy and its Implementation.* Expertise will be provided to FSC's Financial Reform Planning Unit to assist FSC's senior management in further refining the overall strategy for sound management of financial crisis. This will include the development of principles, processes, analytical tools, and operational capabilities to refine resolution strategies. The consultants will also advise on the implementation of crisis resolution and structural reform measures in the financial sector.

- *Development of Methodologies and Generation of Data for Financial Institution Resolution Strategies.* Consultants will help develop methodologies to design, evaluate, and implement alternative financial institution resolution strategies that aim at building a sound financial sector structure. Consultants would also help generate data on financial institutions from within and outside these financial institutions, as inputs into the decisions on financial sector crisis management and structural reform. In particular, consultants will advise FSC on the assessment of financial institution rehabilitation plans.

Most of the assistance would be provided by individual experts and consultant firms that have successfully participated in the crisis resolution and bank restructuring in the financial sector of other countries in recent years.

Timing: 7/1998-9/1999 (15 months)

Project Component 2: Securities Markets Development — US$1.95 million
(of which Loan: US$1.44 million)

2.1 Securities Markets Regulation, Infrastructure, and Industry (US$0.7 million)

The recent financial crisis has revealed a number of issues in Korea's financial and corporate sectors which have profound implications about both urgent and medium-term needs to develop the capital markets. First, Korea's corporate financing pattern needs to diversify away from the excessive reliance on short-term bank borrowing to market-based long-term financing particularly through the equity market to avoid excessive leveraging. This includes a likely need to convert a significant amount of the existing corporate debt into equity. It would unlikely be achieved only by attracting foreign investment but require deep and efficient domestic capital markets. Therefore, Korea's capital markets need to become a truly attractive and competitive place to raise, invest and trade capital, and securities intermediaries and institutional investors must be sound and competitive. Market institutions such as the Korea Stock Exchange (KSE) must become not only operationally effective but also cost competitive. The functional role sharing among the market institutions warrants rationalization, and gray areas due to introduction of new financial instruments such as interest rate derivatives need to be clarified. These would require fundamental review of policies for intermarket competition and overall market architecture. Work in this area would require close coordination with work on trading market for government bonds.

Secondly, in order for Korea's financial institutions to enhance their risk-sensitivity and encourage sound financing practice of their client corporations, they will be given greater self-responsibility to manage their own business risks. This would also require tightening up prudential regulation as a "stick." The recent extensive liberalization of the country's capital account also means that much of the necessary risk management now needs to be done by the private sector themselves. Thus, the framework of Korea's financial market regulation needs to vertically delegate greater regulatory responsibilities to private hands. This would complete the reform of the institutional framework of regulation by supplementing the on-going horizontal integration of the government regulators. Greater emphasis on self-regulation is inseparable from redefining Korea's market architecture and structure of the market institutions as mentioned in the above paragraph, since organized trading markets and clearing and settlement institutions play and are expected to play the role of self-regulatory organization (SRO). Currently, KSE and Korea Securities Dealers' Association (KSDA) have legally recognized SRO status.

Thirdly, lack of transparency and effective governance of Korean corporations failed to bring market discipline to their financing practice. Other components of this Project will address accounting and disclosure standards and rules for corporate actions. Such rules and standards must, however, be accompanied by an effective mechanism of delivering them. This is to be achieved through the systems and business procedures of the securities market according to the regulations stipulated and enforced by the securities regulator. The recently instituted company-form mutual funds with regulations to address potential agency problems will be a useful vehicle to ensure transparent and independent relationships among the funds, their management companies and the invested companies while also useful in supporting the corporate restructuring. The other existing institutional investors must also be strengthened to mobilize savings and to be more active as owners to ensure financial discipline of the invested corporations.

To carry out policy actions agreed to under the SAL, a Taskforce on the Advancement of Capital Markets was created upon MOFE's initiative. The reform efforts of this Taskforce in selected critical areas of the securities market and industry will be assisted through MOFE:

- reform of the regulatory framework of the securities market with a greater emphasis on self-regulation and prudential regulation including strengthening of risk management capacity of securities firms and institutional investors; and
- rationalization of the market architecture and the ownership, governance and functions of the market institutions in order to enhance efficiency, safety, transparency and competitiveness of the market places.

A primary focus will be placed on assisting efforts by the Taskforce on Advancement of the Securities Market, or successor hereto, to draft reform proposals in the above areas and subsequently support implementation of the proposals. The assistance will include financing of detailed review and comments on the reform proposals by consultants; overseas study tours of Taskforce members; the organization of international seminars/ workshops; the acquisition of research materials; and studies of systems and practices of foreign markets by consultants (with extensive relevant work experience in securities markets of several foreign countries) working with the Taskforce.

The main outputs of this sub-component would include:

(i) Reform of the regulatory framework:

- defining the role of SROs and their member firms, and rules for granting a SRO status; drafting of a model code of conduct for the securities industry and rules for its enforcement; recommendations for regulatory and supervisory role sharing and mandatory cooperation among FSC/SSB, SROs and their member firms, including differentiation of rules for going public and those for listing; and recommendations for information technology capacity building required for effective cooperation, strengthening of systems and institutions for training and licensing of securities industry professionals such as brokers, fund managers, securities analysts and derivative specialists;
- defining consolidated prudential regulations for a securities firm as part of a financial conglomerate, supervision of compliance with prudential regulation including manuals for auditing of risk management capacity of market intermediaries, development of a model middle office system for automated accounting and risk management for the securities industry to monitor, report and manage consolidated net capital positions, model professional licensing system; and
- recommendations for steps to introduce the mark-to-market accounting requirement for intermediaries and institutional investors and securities lending, borrowing and short-selling, including tax policy for gains and losses through mark-to-market and transactions of securities lending, borrowing and short-selling (Note that this part needs to be coordinated closely with recommendations under the Subcomponent on Bond Market Development.).

(ii) Rationalization of the market architecture:

- policy recommendations for intermarket competition including, concentration of order flows, trading of non-listed securities and listed companies outside the KSE and/or KOSDAQ, trading rules/algorithms (order-driven versus quote-driven, etc.), policy for proprietary trading systems, and definition of and licensing for an organized trading market (Note that Market Infrastructure of the Subcomponent on Bond Market Development will be a key component of this outcome.);

- recommendations for rationalizing functional role of organized trading markets (KSE, KSDA, etc.), the clearing and settlement organization, the governance / ownership of those market institutions, and for revision of relevant laws, regulations and by-laws (e.g., realignment of location of the settlement guarantee fund, concentration of client accounts in an integrated depository/registrar, policies for separation of the futures market and the stock exchange, etc.); and
- recommendations for clarifying policies regarding licensing/authorization of organized market places, legal definition of an "organized trading market", policy for proprietary trading systems and inter-market competition.

(iii) Study of the demand on bond markets:

- In-depth diagnosis of the demand side of bond markets in Korea, looking in detail at existing legal, regulatory, and institutional obstacles to the extensive use of key institutional demand vehicles such as mutual funds, life insurance, and pension funds. The study would also quantify the current and potential demand for bonds. Moreover, it would address tax issues at the individual and institutional level, as well as specific considerations related to the competitiveness of securities taxation for international investors. Finally, policy recommendations will be elaborated for high-level policy-makers particularly in the President's Office, MOFE, and FSC, addressing the above identified barriers to bond market demand as well as supporting policies for bond market development.

Timing: 9/1998-12/1999 (15 months)

2.2 Development of Government Bond Markets (US$0.7 million)

Bond markets in Korea are comparatively less well developed than in many other industrialized countries. A well developing bond market would be important for capital market development in general, help diversify investor risk, and provide enterprises with non-bank financing. The basic non-risk government Treasury market is underdeveloped, to the extent that the market does not have a well-shaped yield curve.

The overall objective would be an efficient and self-sufficient bond market in Korea. To this end two sets of activities may overlap in time: (i) A primary program aimed at ensuring a sound basic framework, which should be built on a strong demand for bonds and a major sound issuer; and (ii) a consolidation program focused on improving market efficiency and providing a stimulating environment for innovation. The diagnosis of demand for bonds has been included in the above sub-component 2.1 since it will, like the other elements of sub-component 2.1, involve the Taskforce on the Advancement of Capital Markets and the Korea Securities Research Institute as the main parties working directly with the consultants.

The main outputs of sub-component 2.2 would be:

(i) Government bond management policy:

- Study and recommendations regarding the role of active Government bond management policy. Among other things, the study will look into the implications of increased public spending for Government bond market development, and the efficiency of Government bond management including redemption.

(ii) Efficiency improvements in primary and secondary markets for Government bonds:

Consultant advice and workshops would address selected measures to transform the Government bond market into a liquid and transparent market in a short period of time. This will include in particular the primary and secondary markets as indicated below. To lesser extent, it will address the infrastructure of the derivatives and over-the-counter markets.

- Strengthening of the primary market for Government securities through improvement in the organization of government auctions and the use of buy-backs and substitution schedules to strengthen more fungible issues; and
- improving the liquidity and trading in the secondary market through the implementation of a market-maker / primary dealer network, some system to provide market-makers with liquidity or bonds as a source of last resort, and instruments and regulations that allow market-makers to carry out repo transactions as well as the borrowing and lending of bonds.

Timing: 9/1998-1/2000 (16 months)

2.3 Accounting and Audit Reform (US$0.55 million)

The recent financial crisis in Korea has revealed that accounting practices have in many respects been poor, financial disclosures have been inadequate, and the quality of audit reports has generally been unsatisfactory. Poor corporate governance along with weak audits also failed to reveal underlying deficiencies and provide early warning signals to management, owners, investing publics, and the government about the unsound business practices and imprudent financial management. The enhancement of financial accountability and transparency in business dealings through improved accounting and audit practices needs to be a high reform priority.

The Korea Institute for Chartered Public Accountants (KICPA) has not been in a position to take a leadership role in ensuring the adaptation of consistent accounting and auditing standards, and in monitoring the quality of auditing and accounting practices. The Government has been strongly involved in setting standards, ensuring compliance, and regulating the profession. The role of the Government needs to be reduced, while the role of the KICPA must be enhanced. In addition, an independent standard-setting organization should be established. Strengthening of institutions responsible for ensuring accountability is critical for the country's reform strategy, and have been agreed under the SAL. In the first half of this year, the authorities have undertaken a range of measures to strengthen accounting and audit.

The Project would improve the transparency of accounting and audit practices, enhance the institutional framework, and strengthen the financial oversight, through reviewing measures for:

- development and implementation of an enhanced Continuing Professional Education program for all qualified accountants, and education of accountants with respect to the role of corporate governance, including audit committees and effective internal audit;
- enhancement of the system of professional ethics, especially the independence rules, and of the code of conduct for qualified accountants;
- rationalization of the institutional framework for setting standards, regulating, and overseeing the accounting and auditing profession, through:
  - strengthening the role of KICPA so that KICPA will be responsible for setting auditing standards, regulating, and monitoring the quality of its members, and ensuring implementation of standards consistent with international standards;
  - establishing an independent organization responsible for setting accounting standards;
- expanding the scope of external audit to include government-run enterprises, major hospitals and schools, religious foundations, and other entities that enjoy major special tax benefits, and to introduce a market-based contract system that eliminates the ceiling for the number of auditors' client firms; and

- the feasibility of introducing audit committees of boards of directors for listed companies, banks, and other financial institutions.

The above reviews would be carried out by consultant teams consisting of both international and local experts. MOFE would recover part of the assistance costs from KICPA.

Timing: 9/1998-3/1999 (6 months)

Project Component 3: Debt Management Improvement (US$2.5 million)
(of which Loan: US$2.0 million)

Improved management of Government debt would contribute to future financial stability. The overall objective would be sound management of government debt. The main outcomes to achieve this objective would be strengthened professional capability, appropriate organizational arrangements, and improved information and communication systems for debt management.

The component would address the following areas:

- a general information framework for sovereign debt management;
- an "early warning" model regarding foreign exchange exposure;
- a methodology for elaborating a debt profile and analysis;
- the quantification of currency and interest rate risk of the debt portfolio;
- the design of debt benchmarks that explicitly capture the levels of risk (liquidity, currency, refinancing, and other risk) that the government is willing to tolerate (measuring the risk in millions of Won of deviation from the debt service budget in a given year);
- the design of a hedging and financing plan for meeting the benchmarks, aimed at optimizing natural coverage and the use of derivatives. The project would incorporate an explicit asset/liability framework, as well as the selection, evaluation, and use of derivative products (currency and interest rate) when natural coverage is no longer available to achieve the Benchmark; and
- information/communication systems for the front, middle, and back office functions of public debt management.

The project would cover all public debt, although it might initially start with external debt. It also needs to include contingent liabilities such as guarantees, given the wide use of Government guarantees provided to debt instruments issued by, for example, the Deposit Insurance Corporation and the Korea Asset Management Corporation.

The main outputs of this component would be:

- consultant reports including detailed recommendations for each of areas listed above, based on about fourteen personmonths of consultant input;
- capacity building mainly through on-the-job training and four workshops; and
- information/communication systems as indicated above, through the procurement of hardware and software estimated at US$1.2million.

Timing: 9/1998-9/2000 (24 months)

Project Component 4: Corporate Restructuring — US$32.7 million
(of which Loan: US$30.5 million)

The precarious financial position of Korea's large business groups ("*chaebols*") poses a severe concern to Korea's financial institutions and economy. The 30 largest of the more than sixty *chaebols* accounted late last year for about one million employees and over Won 110 trillion in bank loans. The average debt/equity ratio for these *chaebols* increased from about 360 percent at end-96 to some 520 percent at end-97 -- or to about 600 percent at end-97 if financial affiliates are included. By last May, seven *chaebols* were in bankruptcy proceedings. Another ten *chaebols* with average debt/equity ratios of about 1,000 percent have received about Won 2 trillion in emergency loans. The authorities have been concerned that several major additional bankruptcies could provoke large-scale unemployment and social unrest, bank failures, and outflows of foreign currency and portfolio investment, leading to additional pressure on the Won and interest rates.

While this holding action proceeded, the Government created a Structural Reform Planning Unit under FSC. This Unit had developed a proactive strategy for pursuing voluntary workouts. Elements of this strategy include, *inter alia*, prompt "triage" analysis of large corporates by the main creditor banks of their *chaebols*; reliance on these lead banks to orchestrate voluntary workout negotiations; and creation of a standing arbitration committee to resolve inter-creditor disputes.

In May, the creditor banks carried out a first, rough triage of their main borrowers. In June, the banks announced to cut off further funding to 55 corporations that the lead banks had reported as most clearly non-viable, including the former recipients of the emergency loans. For other weak borrower corporations, the viability analysis is being deepened. The authorities have also instructed the *chaebols* to reduce their debt/equity ratios substantially. In response, a number of *chaebols* are pursuing asset sales to foreign and local buyers, and the mobilization of additional equity capital especially through foreign investment. Reducing financial leverage to sustainable prudential levels and restoring necessary liquidity will also require widespread debt/equity conversions, various other forms of debt restructuring, and the closure of non-viable business lines.

While some *chaebols* have been pushed into bankruptcy, and the threat of court-supervised proceedings can usefully encourage debtors and creditors to reach agreement, Korea's courts and practitioners face great difficulties developing, negotiating, and implementing a large number of large and complex corporate reorganizations and liquidations. To avoid unnecessarily deep economic disruptions and destruction of wealth, Korea needs institutions and procedures to facilitate timely completion of a large number of voluntary debtor/creditor workouts. In June, financial institutions including the main creditor banks agreed formally on the creation and operating rules of an arbitration committee (Corporate Restructuring Coordination Committee) to resolve inter-creditor disputes. FSC has suggested to financial institutions a set of procedures for voluntary, credit-led work-out akin to the "London rules".

Extensive assistance by international experts will be required to further prepare and carry out corporate restructuring of the necessary magnitude. Many of the required skills are highly specialized, rare in a country that had earlier experienced hardly any major corporate work-outs, and needed on a large scale due to the depth and scope of Korea's corporate restructuring challenge. Moreover, the advisors should bring international best practice to bear, and should have the capability to bring potential foreign investors to work-out situations.

The basic objective of the assistance project is to promote timely corporate restructurings, while avoiding excessive economic dislocation and strengthening the ability of financial institutions to undertake corporate workouts. In particular, the technical assistance is expected to have the following impact:

- decreases in debt/equity ratios for Korean corporates, especially among *chaebols*;
- restoration of *chaebol* liquidity and competitiveness, with rapid trickle-down benefits for SMEs;
- a more robust economy resulting from a shift from excessive reliance on debt financing toward greater equity financing;
- avoidance of unnecessary strains on Korea's court system as a result of excessive numbers of bankruptcies;
- building of sustainable institutional capacity, especially in the main creditor banks, for corporate restructuring; and
- strengthening of procedures and institutions to support the timely conclusion of large and complex voluntary workouts.

Financial advisory consortia would support some eight lead banks in developing, negotiating, and enforcing the implementation of work-outs with large corporations belonging to *chaebols*. Moreover, in a small number of particularly difficult cases of large work-outs, these advisory consortia would provide additional capacity to lead banks to provide in-depth diagnostic reviews and restructuring assistance. These consortia would have wide access to corporate management and management information in return for the corporation's participation in voluntary work-out proceedings. The financial advisory consortium to each lead bank would be expected to include an investment bank, strategic consulting firm, accounting firm, and law firm.

Although each consortium would work directly at one lead bank in close day-to-day collaboration with and under the operational supervision by the bank's professionals and managers, all the consortia would be contracted by FSC. This would ensure a certain stability of the advisory assistance while many of the lead banks will themselves undergo mergers or other forms of drastic restructuring. Moreover, some lead banks are expected to be in a difficult financial situation, and may in any case require state financial support for recapitalization. Finally, this arrangement would help provide FSC with early information on restructuring needs in the banks' portfolio and thus facilitate the necessary coordination between bank and corporate restructuring. However, FSC would over time recover costs of the assistance from the lead banks.

The main outputs of this component would be:

- Detailed recommendations for the development, negotiation, and implementation of voluntary corporate/financial restructuring of *chaebol* or *chaebol* affiliates that provide fair, equitable, and realistic treatment for all creditor financial institutions;
- business diagnostics and restructuring recommendations for corporates undergoing voluntary workout;
- support in the presentation of enterprise assessments and work-out proposals to the creditors' arbitration committee; help with the assessment of alternative work-out proposals put forward to the committee; and work with the lead banks in response to the committee's decisions;
- monthly progress reports as well as quarterly and ad hoc briefings to FSC about progress and issues in corporate restructuring, which would facilitate FSC's anticipation of risks associated with widespread corporate restructuring and inform continuous improvements of the institutional, regulatory, and policy framework for market-based corporate restructuring; and

- building institutional capacity for corporate work-out particularly in the main creditor banks through close daily collaboration with bank staff and managers.

Timing: 8/1998-10/2000 (26 months), with strong front-loading.

Project Component 5: Corporate Legal/Regulatory Reform — US$1.7 million
(of which Loan: US$1.5 million)

5.1 Insolvency System (US$1.1 million)

Korean corporations are facing a sharp deterioration in both balance sheet solvency and liquidity, in part as a consequence of poor management of their external liabilities. Trade debtors have traditionally relied on deferred payment terms and deferral terms are lengthening in the face of the economic downturn and their own financial difficulties. Debt finance raised by corporations in local currency is carrying historically high interest rates. Foreign currency denominated debt service costs are vulnerable to wide swings in foreign exchange rates. The combination of these effects with the high leverage ratios typical of Korean corporates has led to increases in bankruptcy filings (around 4,000 per month) and, in the case of several large conglomerates, to the suspension of normal payments to creditors and to the cessation of trading activities.

Against this background, the ultimate objective of the technical assistance is to help build a more reliable corporate insolvency system that ensures a balance of stakeholder interests. In particular, the technical assistance is expected to have the following impact:

- an increase in agreements between debtors and creditors for restructuring of liabilities outside the court system;
- modernization of the insolvency laws to conform to international best practices;
- institutional strengthening of the court system to manage historically high levels of bankruptcy and reorganization filings;
- increased confidence of creditors and increased public awareness of the role of insolvency systems in a modern economy; and
- strengthened ability of the authorities to make further adaptations in response to economic circumstances.

To achieve this, the assistance aims at the following outcomes:

- strengthened incentives for creditors and debtors to negotiate agreements for the reorganization of corporate debt subject to confirmation by the courts that the agreement is fair to creditors;
- improved capacity of the courts to assess the potential viability of distressed corporations and to oversee corporate reorganizations;
- evaluation of the benefits of the establishment of specialist bankruptcy courts;
- training provided to judges, officials and insolvency practitioners on the implementation of an improved insolvency system;
- improvements identified to the principal laws concerned with corporate insolvency; and
- increased public awareness of the benefits for the economy of a reliable and credible insolvency system.

The sub-component would start with the establishment of the steering committee (including representatives of the Ministry of Justice, MOFE, FSC, the bar association and the judiciary, and potentially banks and the business community); the selection and appointment of consultants to carry out an evaluation of the insolvency system and a work plan for revision of laws, institutional strengthening and training; and the presentation of the work plan to the implementation unit and approval of the plan.

The main outputs would then be:

- completion of the diagnostic review;
- presentation of the findings at a workshop on insolvency reform;
- finalization of the work plan;
- preparation of insolvency law changes;
- decision on possible establishment of specialist bankruptcy courts;
- training program for judges, officials and insolvency practitioners, including overseas training for select court and Ministry of Justice officials; and
- wide public dissemination and education about the reformed insolvency system.

The main inputs would be the engagement of consultants; the organization and delivery of a workshop; the engagement of trainers; and the use of public media and other means of dissemination.

Timing: 9/1998-12/2000 (15 months).

5.2 Corporate Governance Framework (US$0.6 million)

Government policy for the Korean financial sector is to encourage an expanded role for the capital markets in the provision of both debt and equity financing and thereby to reduce the demands on the banking system and to improve liability structures for non-financial firms. Other benefits of an expanded role for the capital markets will be a demand for high-quality financial information and the emergence of institutional investors seeking investment opportunities for inflows gathered from the general public. The two pillars of this shift will be the adoption of international best practices for financial reporting, and credible mechanisms to encourage monitoring of corporate performance by directors, shareholders, creditors, regulators and the media.

The assistance would address the latter of the two above pillars: the adoption of credible mechanisms for corporate monitoring by stakeholders. In particular, the assistance would be expected to have the following impact:

- the adoption of clear standards for the duties of care and loyalty of directors;
- the creation of incentives for directors to monitor managerial actions to ensure that the best interests of the company are served;
- increased independence of corporate directors from management and dominant shareholder interests;
- generally improved accountability and effective corporate decision-making; and
- enhanced ability to make further adaptations in response to economic circumstances.

To achieve this, the assistance aims at the following outcomes:

- To strengthen and refine the duties of care and loyalty owed by corporate directors to companies and shareholders;
- to evaluate, in the Korean context, the role and functions of corporate directors as policy-makers and monitors of managerial performance;

- to study and provide recommendations on the selection, appointment and removal of corporate directors and their accountability to shareholders;
- to evaluate the benefits of the appointment of outside directors and their roles in strengthening the effectiveness of outside auditors and in managerial oversight;
- to strengthen the rights of shareholders to obtain information, present proposals, approve the appointment and removal of directors, and hold management and directors accountable for corporate actions; and
- to strengthen the capacity of Ministry of Justice and MOFE officials with regard to the framework for corporate governance.

A steering committee would be established including representatives of the Ministry of Justice, MOFE, and the securities supervisory authority, and potentially of the business community and shareholder advocacy groups.

Main outputs of this component would be:

- a study of the role and functions of boards of directors as users of corporate financial information for policy-making purposes and to monitor managerial performance;
- preparation of changes to laws to strengthen the duties of directors to act in the best interests of the company and to reduce or eliminate barriers to the exercise of minority shareholder rights;
- a study of the possible introduction of class action law suits by shareholders of listed companies;
- a workshop on corporate governance reform to present the findings of these studies; and
- overseas training for selected Ministry.

The main inputs would be the engagement of consultants for the above two first outputs, and further consultants for the third output, as well as the organization and delivery of a workshop that would involve these consultants and other speakers as resource persons.

Timing: 9/1998-12/2000 (15 months)

Project Component 6: Competition Policy — US$0.61 million
(of which Loan: US$0.42 million)

Under the Structural Adjustment Loan program, the government of Korea has agreed to strengthen the administration and enforcement of competition policy. The intended impact is to help foster competition and efficiency in the financial and industrial sectors. Aimed at this ultimate objective, the outcomes of the assistance should be a certain increase in the effectiveness of the Korean Fair Trade Commission (KFTC), and strengthened application of the Fair Trade Act. This would be achieved through enhanced skills and knowledge of KFTC staff; experience in applying selected international best practice to local circumstances; and the development of solutions to some specific technical issues.

The main outputs of this component would be:

- Some policy statements, guidelines, regulations, and procedures drafted with the help of knowledge and inputs provided by experts from OECD countries;
- two training workshops; and
- internships for KFTC officials in OECD member country competition offices, combined with the participation in overseas seminars/workshops.

The main activities would be:

- Sharing of knowledge from various countries, including OECD best practice, as well as direct inputs into select draft policy statements, regulations, procedures, etc., by three advisors visiting KFTC for an average of two months each. International experts would be drawn from OECD member country competition offices, recognized experts in the field, legal and economic practitioners;
- training seminars / workshops, to the extent possible organized back-to-back with events involving some of the same lecturers, and/or organized jointly with other organizations such as the OECD. In Korea, organizations such as KDI, KIET, Universities and individual professionals would be relied on. Two events are foreseen, with the first event being planned for September 1998;
- combined internships/training for about six KFTC officials abroad for an average period of three months, and for two additional officials for an average stay of nine months. These visits could be arranged through universities, other training institutions, and OECD country competition offices. KFTC currently has already six staff abroad in secondments at competition policy offices for a year or more, funded from other sources.

Timing: 9/1998-9/2000 (24 months)

Project Component 7: Project Implementation Support — US$0.22 million
(of which Loan: US$0.20 million)

A Project Implementation Unit (PIU) has been established within the Planning and Administration Department of FSC, and a second PIU is being established within the Treasury Division of MOFE. These PIUs would, inter alia, manage special accounts, carry out accounting, engage independent auditors, prepare and send disbursement requests to the Bank, advise the technical implementing agencies in procurement matters consistent with Bank guidelines, and compile project progress reports.

Each of the two PIUs would use US$100,000 funding under the Loan to cover expenses for consultant services and training including, inter alia:

- PIU staff training in procurement, disbursement, and other technical matters;
- consultant services regarding financial accounting under World Bank projects; and
- services of independent auditors.

Timing: 8/1998 - 12/2001 (40 months)

ANNEX 3: ESTIMATED PROJECT COSTS
(US$ million)

Project Component	Local	Foreign	Total	IBRD Financing
1. Financial Sector Supervision and Crisis Management	**0.9**	**8.7**	**9.6**	**7.30**
1.1 FSC Institutional Development	0.4	4.2	4.6	3.30
1.2 Financial Sector Crisis Management Capability	0.5	4.5	5.0	4.00
2. Securities Markets Development	**0.4**	**1.6**	**2.0**	**1.44**
2.1 Market Regulation, Infrastructure, Industry	0.1	0.6	0.7	0.56
2.2 Government Bond Markets	0.2	0.5	0.7	0.38
2.3 Accounting and Audit Reform	0.1	0.5	0.6	0.50
3. Government Debt Management	**0.6**	**1.9**	**2.5**	**2.00**
4. Corporate Restructuring by Lead Banks	**1.8**	**30.9**	**32.7**	**30.50**
5. Corporate Legal/Regulatory Reform	**0.3**	**1.4**	**1.7**	**1.50**
5.1 Insolvency System	0.2	0.9	1.1	1.05
5.2 Governance Framework	0.1	0.5	0.6	0.45
6. Competition Policy	**0.1**	**0.5**	**0.6**	**0.42**
7. Project Implementation Support	**0.1**	**0.1**	**0.2**	**0.20**
Total Baseline Cost	**4.2**	**45.1**	**49.3**	**43.36**
Physical Contingencies	0.2	0.5	0.7	0.60
Price Contingencies	0.3	4.2	4.5	4.04
Total Project Cost	**4.7**	**49.8**	**54.5**	**48.00**

ANNEX 4: COST EFFECTIVENESS ANALYSIS SUMMARY

Not Applicable

ANNEX 5: FINANCIAL SUMMARY

Years Ending June 30

US$ million

	Implementation Period				
	FY99	FY00	FY01	FY02	TOTAL
Project Costs	28.0	20.0	5.4	1.1	54.5
Financing Sources					
IBRD	23.0	19.0	5.0	1.0	48.0
Government	5.0	1.0	0.4	0.1	6.5
Total	**28.0**	**20.0**	**5.4**	**1.1**	**54.5**

ANNEX 6: PROCUREMENT AND DISBURSEMENT ARRANGEMENTS

Procurement

Procurement methods (Table A). Goods shall be procured in accordance with the provisions of Section I of the "Guidelines for Procurement under IBRD Loans and IDA Credits" published by the Bank in January 1995 and revised in January and August 1996 and September 1997 (the Guidelines). Procurement of consultants would be done according to the provisions of the "Selection and Employment of Consultants by World Bank Borrowers" (the Consultant Guidelines). All consultants assignments will follow the Bank's Standard Request for proposals dated April 1998. Except as otherwise provided, consultants' services shall be procured under contracts awarded in accordance with the provisions of the Consultant Guidelines applicable to quality- and cost-based selection of consultants.

Thresholds for procurement methods and prior review (Table B).

Single Source Selection. This project has been prepared in response to an economic crisis and rapid selection of consultants will be essential in one of the components. Services under sub-component 1.2 (Financial Sector Crisis Management Capability) may, with the Bank's prior agreement, be procured in accordance with the provisions of paragraphs 3.8 through 3.11 of the Consultant Guidelines.

All consultant contracts not procured through single source selection, and exceeding $200,000 would be advertised in Development Business.

Selection Based on Consultants' Qualifications. Services estimated to cost less than $100,000 equivalent per contract may be procured under contracts awarded in accordance with the provisions of paragraphs 3.1 and 3.7 of the Consultant Guidelines.

Individual Consultants. Tasks that meet the requirements set forth in paragraph 5.01 of the Consultant Guidelines shall be procured under contracts awarded to individual consultants in accordance with the provisions of paragraphs 5.1 through 5.3 of the Consultant Guidelines.

Table A of this Section shows the project costs by procurement arrangements. The total expenditure on equipment is limited to US$1.2 million. There will be only one international competitive bidding (ICB) in the Project. Equipment may be procured using international shopping up to an aggregate amount of US$ 600,000, and national shopping up to an aggregate amount of US$300,000. At least three quotations from qualified suppliers must be obtained.

Requirements of prior review of procurement of consulting services and equipment are summarized in Table B.

Disbursement

Allocation of loan proceeds (Table C). Expenditures for individual contracts of equipment and services, for which prior review by the Bank is not required, will be disbursed against Statement of Expenditures. For expenditures incurred on the basis of Statements of Expenditures all records evidencing such information must be retained by the project entity until at least one year after the Bank has received the audit report for the fiscal year in which the last withdrawal from the loan account is made. Full documentation for all contracts requiring the Bank's prior review will be submitted. Disbursements, representing mainly expenditures under short term implementation assistance, will be made over a period of three and a half years.

Since the Government wishes to advance rapidly, with respect to crisis management capability in the financial sectors, corporate restructuring by lead banks, and consolidation of financial sector supervision in the newly created FSC, retroactive financing, not to exceed US$4.8 million (10% of Loan amount), would be applied to finance eligible expenditure, made after June 26, 1998.

Use of statements of expenses. The Bank may require withdrawals from the Loan Account to be made on the basis of statements of expenses for: (i) goods under contracts costing less than US$300,000 equivalent each; (ii) contracts for the employment of consulting firms valued at less than US$100,000 each; and (iii) contracts for the employment of individuals valued at less than US$50,000 equivalent each.

Special accounts: Two special accounts in US dollars will be established at commercial banks acceptable to the Bank. A special account managed by FSC will have an authorized allocation of US$3.0 million, and the second special account, at MOFE, will have an authorized allocation of US$0.5 million. The amount of the initial deposit in FSC's special account, however, would be limited to US$1.5 million, until the aggregate amount of withdrawals by FSC from the Loan plus outstanding special commitments will equal or exceed the equivalent of US$5.0 million to correspond to anticipated expenditures in the first months of project execution. In the case of MOFE's special account, the according amounts will be US$0.25 million and US$1.0 million, respectively. The special accounts will be replenished monthly to assure liquidity of funds, and all replenishment applications would be accompanied by reconciled bank statements from the depository bank showing all transactions in the respective special account.

The allocation of Loan proceeds is provided in Table C of this Section.

Annex 6, Table A: Project Costs by Procurement Arrangements
(in US$million equivalent)

Expenditure Category	Procurement Method				Total Cost
	ICB	NCB	Other	NBF	(including contingencies)
1. **Works**	-	-	-	-	-
2. **Goods**	0.6 (0.6)	-	0.6 (0.6)	-	1.3 (1.3)
3. **Services**	-	-	48.1 (42.2)	-	53.2 (46.7)
4. **Miscellaneous**	-	-	-	-	-
Total	**0.6** **(0.6)**	-	**48.7** **(42.8)**	-	**54.5** **(48.0)**

Notes: NBF = Not Bank-financed (includes elements procured under parallel cofinancing procedures, consultancies under trust funds, any reserved procurement, and any other miscellaneous items).

Figures in parenthesis are the amounts to be financed by the Bank Loan.

Items listed under "other" will be procured through international or national shopping.

Annex 6, Table B: Thresholds for Procurement Methods and Prior Review

Expenditure Category	Contract Value (Threshold)	Procurement Method	Contracts Subject to Prior Review / Estimated Total Value Subject to Prior Review
	US$ thousands		
1. Goods			
	>300	ICB	All.
	<250	International Shopping	First two contracts, and contracts of $100,000 or more.
	<100	National Shopping	None
2. Services			
Firms	>100	Quality and Cost Based Selection (QCBS), except in services identified below.	All. Shortlist and request for proposals only: Below $200,000.
	>100	Single Source Selection for Project Services Identified in the Loan Agreement *	All. Shortlist and request for proposals only: Below $200,000.
	<100	Single Source Selection or based on Consultants' Qualifications (CQ)	TORs only.
Individuals	>50	Consultant guidelines Section V	All.
	<50	Consultant guidelines Section V	TORs only.
		Total value of contracts subject to prior review:	$42.0m

* Where rapid selection of consultants will be essential due to the critical economic situation (para. 3.9 of the Consultant Guidelines). Single-source selection may be used for sub- component 1.2, Financial Sector Crisis Management Capability.

Annex 6, Table C: Procurement Plan

	Main Consultant Contracts	Notice for Expression of Interest	Expression of Interest Submitted	Request for Proposals	Proposals Received	Contract Award	Consultants Start
1.1	Development of Financial Supervision Strategies, Policies, Procedures, Capabilities	8/98	9/98	9/98	10/98	10/98	10/98
1.1	FSC Human Resource Development Policy	8/98	9/98	10/98	11/98	11/98	11/98
1.1	Implementation of New Organizational Structure of FSC	8/98	8/98	8/98	9/98	9/98	9/98
1.2	Strategy for Financial Sector Crisis Management (sole-source procurement)	-	-	7/98	8/98	8/98	8/98
2.1	Securities Markets Regulatory Framework	8/98	9/98	9/98	10/98	10/98	11/98
2.1	Advice on the Rationalization of Securities Markets Architecture (first contract; sole-source procurement)	-	-	8/98	8/98	9/98	9/98
2.1	Bond Market Study	8/98	9/98	9/98	10/98	10/98	11/98
2.2	GOK Bond Management Policy Study	8/98	9/98	9/98	10/98	10/98	11/98
2.3	Review of Measures to Improve Accounting and Audit (first contract)	7/98	8/98	8/98	9/98	10/98	10/98
3	Debt Management Improvement (first set of contracts; sole-source procurement)	-	-	8-9/98	8-9/98	9-10/98	9-11/98
4	Corporate Restructuring (8 similar contracts)	7/98	7/98	7/98	8/98	8-10/98	8-10/98
5.1	Insolvency System Diagnostic and Workplan	8/98	9/98	9/98	11/98	12/98	12/98
5.2	Study/Advice on Corporate Governance (main contract)	8/98	9/98	9/98	11/98	12/98	12/98
6	Competition Policy (first contract; sole-source procurement)	-	-	8/98	9/98	9/98	9/98

Annex 6, Tablle D: Allocation of Loan Proceeds

Expenditure Category	Amount in US$million	Financing Percentage
Consultants' Services and Training	42.2	100% of all foreign expenditures, 100% of local expenditures
Equipment	1.2	100% of foreign expenditures, 100% of local expenditures ex factory cost), and 80% of local expenditures for other items procured locally
Unallocated	4.6	
Total	**48.0**	

ANNEX 7: PROJECT PROCESSING BUDGET AND SCHEDULE

	Planned (At final PCD stage)	Actual
A. Project Budget (US$'000)	Preparation: 300	-
B. Project Schedule		
Time taken to prepare the project (months)	3	
First Bank mission (identification)	4/27/1998	4/27/1998
Appraisal mission departure	6/18/1998	6/25/1998
Negotiations	6/29/1998	7/14/1998
Planned Date of Effectiveness	9/1/1998	8/20/1998

Prepared by: Ministry of Finance and Economy

Preparation assistance: Special Financial Operations budget

Bank staff who worked on the project included:

Name	Specialty
Klaus Lorch	Task Team Leader
Hong-Chul Ahn	Deputy Task Team Leader
Hongjoo Hahm	Initial Task Team Leader
Katie Shaw	Team Assistance
Ira Lieberman	Corporate Restructuring
William Mako	Corporate Restructuring
David Scott	Financial Sector
Mario Reyes Vidal	Banking Sector
Laura Ard	Banking Sector
Clemente del Valle	Securities Markets
Noritaka Akamatsu	Securities Markets
Douglas Webb	Corporate Governance
Rughvir Khemani	Competition Policy
Behdad Nowroozi	Accounting/Audit; Financial Management
Clifford Garstang	Legal Matters
Gaye Lindsey	Disbursement
Jean Aden	Environment
Surinder Malik	Peer Review
W. Bernard Drum	Peer Review
Arvind Gupta	Peer Review

ANNEX 8: DOCUMENTS IN THE PROJECT FILE*

A. Project Implementation Plan

B. Bank Staff Assessments

None.

C. Other

Background Notes on Corporate Financial Structure and on Lead Banks for Corporate Restructuring

*Including electronic files.

ANNEX 9: STATEMENT OF LOANS AND CREDITS

A. IBRD Loans and IDA Credits in the Operations Portfolio (as of July 17, 1998)

Project ID	Loan or Credit No.	Fiscal Year	Borrower	Purpose	Original Amount in US$ Millions				Difference Between expected and actual disbursements a/		Last ARPP Supervision Rating b/	
					IBRD	IDA	Cancellations	Undisbursed	Orig	Frm Rev'd	Dev Obj	Imp Prog
Number of Closed Loans/credits: 125												
Active Loans												
KR-PE-4170	IBRD 36130	1993	REP OF KOREA	PTRL DIST & SEC MGMT	120.00	0.00	0.00	19.77	19.77	19.77	S	S
KR-PE-4171	IBRD 36120	1993	GOVT OF KOREA	ENVIRON RESEARCH & E	60.00	0.00	0.00	8.92	9.40	0.00	HS	HS
KR-PE-4169	IBRD 35900	1993	ROK	SEOUL & KWANGJU SEWE	110.00	0.00	64.39	11.80	76.18	0.00	S	S
KR-PE-4174	IBRD 36940	1994	GOK	ENV TECHNOLOGY DEVEL	90.00	0.00	0.00	8.29	10.41	0.00	HS	S
KR-PE-4168	IBRD 36930	1994	GOK	SCI & TECH EDUC SECT	190.00	0.00	0.00	39.42	4.40	0.00	HS	HS
KR-PE-4172	IBRD 36890	1994	KOREA GOVERNMENT	FINCL INTERMEDIATION	100.00	0.00	.18	1.10	1.28	.40	S	S
KR-PE-35079	IBRD 38300	1995	GOK	WASTE DISPOSAL PROJE	75.00	0.00	0.00	55.46	36.97	0.00	S	S
KR-PE-4175	IBRD 38280	1995	KOREA GOVERNMENT	PUSAN URB TRANSP.&MG	100.00	0.00	0.00	46.33	34.02	0.00	HS	HS
KR-PE-4173	IBRD 37930	1995	KOREAN GOVENMENT	PORTS DEV & ENVIRON	100.00	0.00	3.07	55.94	45.01	0.00	S	S
Total					945.00	0.00	67.64	247.03	237.44	20.17		

	Active Loans	Closed Loans	Total
Total Disbursed (IBRD and IDA):	630.33	12,185.36	12,815.69
of which has been repaid:	.19	6,212.88	6,213.07
Total now held by IBRD and IDA:	877.16	5,974.22	6,851.38
Amount sold :	0.00	131.51	131.51
Of which repaid :	0.00	131.51	131.51
Total Undisbursed :	247.03	1.75	248.78

a. Intended disbursements to date minus actual disbursements to date as projected at appraisal.
b. Following the FY94 Annual Review of Portfolio performance (ARPP), a letter based system was introduced (HS = highly Satisfactory, S = satisfactory, U = unsatisfactory, HU = highly unsatisfactory): see proposed Improvements in Project and Portfolio Performance Rating Methodology (SecM94-901), August 23, 1994.

Note:
Disbursement data is updated at the end of the first week of the month.

B. Statement of IFC's Committed and Disbursed Portfolio

(As of June 30, 1998, in US$ million)

		Committed				Disbursed			
		IFC				IFC			
FY Approval	Company	Loan	Equity	Quasi	Partic	Loan	Equity	Quasi	Part.
1968/74/76/77/78/80/90/ 94/98	KLTCB	25.00	15.12	0.00	0.00	0.00	15.12	0.00	0.00
1971/74/76/79/80/82/85/ 89/91/94/97/98/97	Hana Bank	50.00	21.55	0.00	0.00	30.00	21.55	0.00	0.00
1974/76/77/79/80/84/85/ 87/88/89/91/92/93/96	LG Electronics	0.00	11.43	0.00	0.00	0.00	11.43	0.00	0.00
1977/79/87/90	KDLC	0.00	1.22	0.00	0.00	0.00	1.22	0.00	0.00
1983/91	KDIC	0.00	1.72	0.00	0.00	0.00	1.72	0.00	0.00
1985	KDIC-Seoshin	0.00	.31	0.00	0.00	0.00	.31	0.00	0.00
1985	KDIC-SK Chemical	0.00	.12	0.00	0.00	0.00	.12	0.00	0.00
Total Portfolio:		75.00	51.47	0.00	0.00	30.00	51.47	0.00	0.00

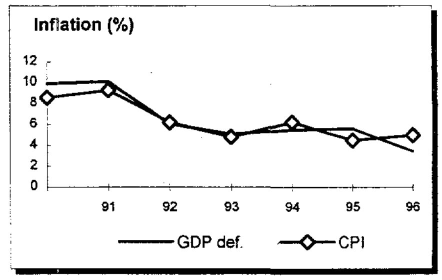
Approvals Pending Commitment

		Loan	Equity	Quasi	Partic
1988	GOLD STAR (12)RI	0.00	2.62	0.00	0.00
1998	H&Q KOREA	0.00	30.00	0.00	0.00
1998	HANA BANK	0.00	21.86	0.00	0.00
Total Pending Commitment:		0.00	54.48	0.00	0.00

ANNEX 10: KOREA AT A GLANCE

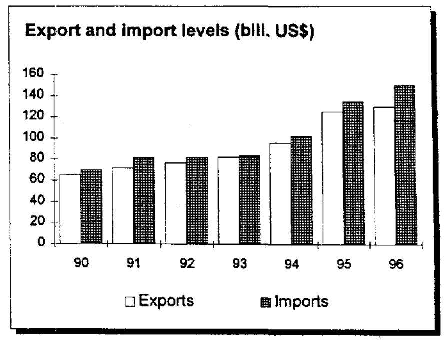
PRICES and GOVERNMENT FINANCE

	1975	1985	1995	1996
Domestic prices				
(% change)				
Consumer prices	25.2	2.4	4.5	5.0
Implicit GDP deflator	26.1	5.6	5.6	3.4
Government finance				
(% of GDP)				
Current revenue	15.2	20.7	20.3	21.5
Current budget balance	..	5.9	6.1	7.3
Overall surplus/deficit	2.0	0.7	0.3	0.3



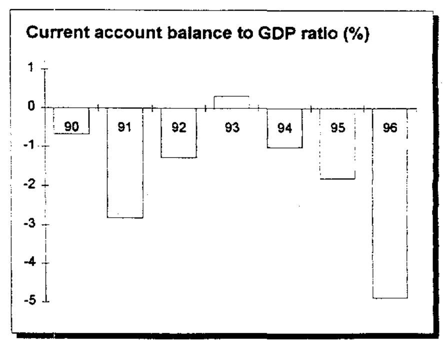
TRADE

	1975	1985	1995	1996
(millions US$)				
Total exports (fob)	4,945	30,282	125,058	129,715
Clothing	..	..	4,958	4,221
Footwear	..	..	1,506	1,236
Manufactures	..	..	106,743	107,175
Total imports (cif)	7,274	31,136	135,119	150,339
Food	..	..	5,925	7,265
Fuel and energy	..	..	19,013	24,284
Capital goods	..	..	49,437	54,675
Export price index *(1990=100)*	31	89	114	114
Import price index *(1990=100)*	34	97	115	115
Terms of trade *(1985=100)*	87	100	102	90



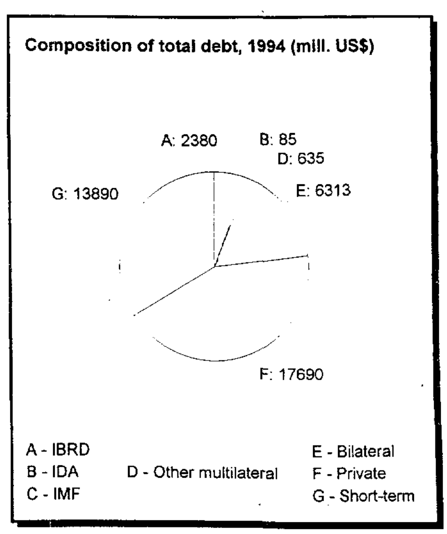
BALANCE of PAYMENTS

	1975	1985	1995	1996
(millions US$)				
Exports of goods and services	5,799	32,038	149,446	156,987
Imports of goods and services	7,543	30,554	155,834	182,758
Resource balance	-1,745	1,484	-6,388	-25,771
Net income	-369	-3,183	-2,276	-2,498
Net current transfers	..	..	..	..
Current account balance, before official capital transfers	-1,889	-758	-8,948	-23,716
Financing items (net)	2,254	950	15,988	23,741
Changes in net reserves	-365	-192	-7,040	-25
Memo:				
Reserves including gold *(mill. US$)*	786.0	2,900.7	32,712.1	34,073.1
Conversion rate *(local/US$)*	484.0	870.0	771.3	804.5

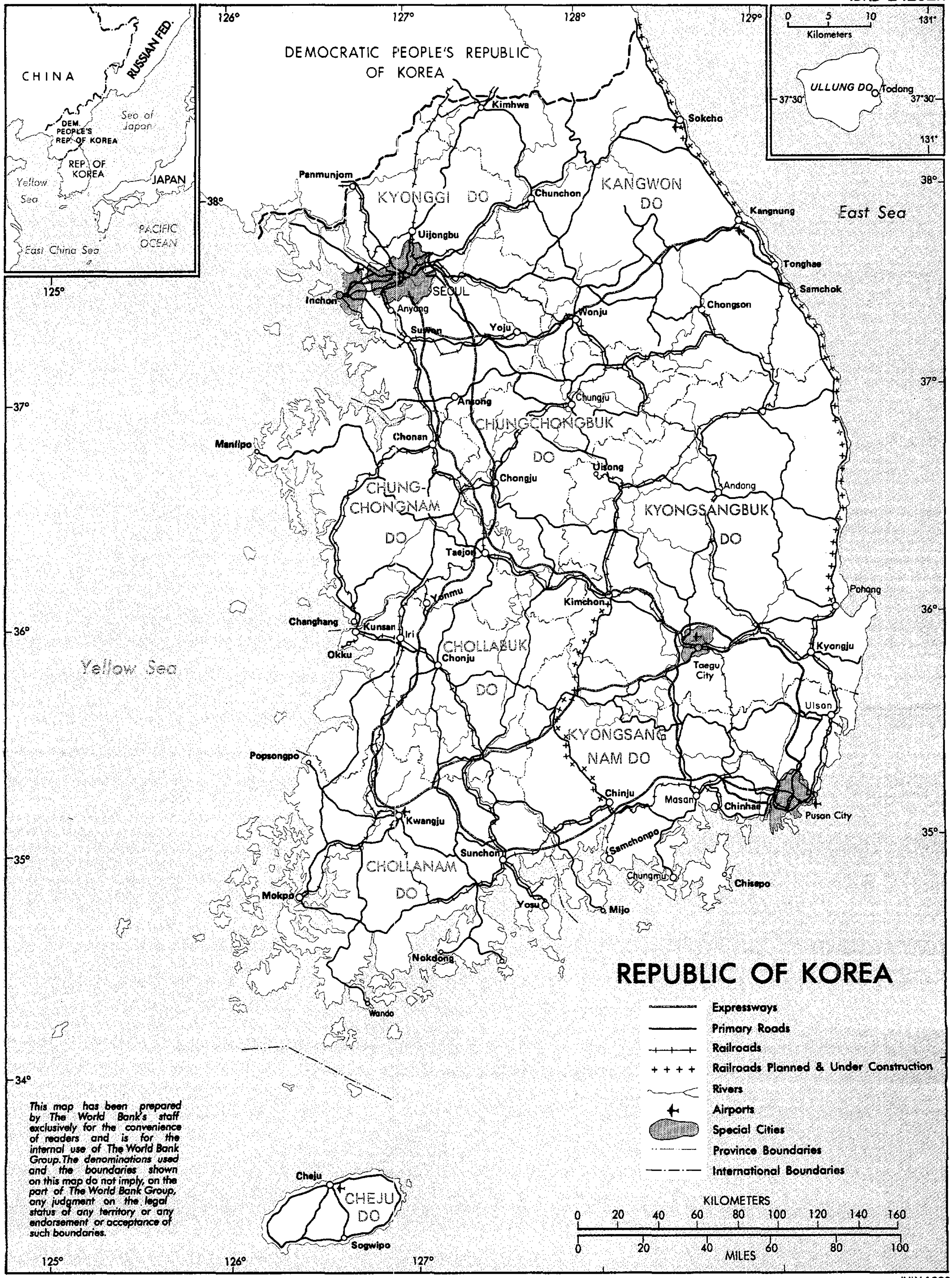


EXTERNAL DEBT and RESOURCE FLOWS

	1980	1994	1995	1996
(millions US$)				
Total debt outstanding and disbursed	29,480	54,542	78,438	160,700
IBRD	1,723	2,380	2,163	1,841
IDA	113	85	82	79
Total debt service	4,449	7,923	..	..
IBRD	211	773	630	527
IDA	2	4	4	4
Composition of net resource flows				
Official grants	..	..	..	..
Official creditors	..	..	..	..
Private creditors	..	..	..	..
Foreign direct investment	6	-1,318	-1,880	-1,981
Portfolio equity	0	7,276	8,518	11,207
World Bank program				
Commitments	..	..	..	..
Disbursements	254	282	144	210
Principal repayments	67	592	464	389
Net flows	187	-310	-320	-179
Interest payments	146	186	169	139
Net transfers	41	-496	-489	-318



IBRD 24232R



JULY 1993